In the United States Circuit Court of Appeals

For the Ninth Circuit

No. 8435

H. E. WARNER, Trustee of the Puget Sound Quality Stores, a Washington Corporation, Bankrupt,

Appellant,

vs.

R. E. SCHONER, C. P. AINSWORTH, J. E. ROULLARD and O. M. FREEBORG,

Appellees.

BRIEF OF APPELLEES

Upon Appeal From the District Court of the United States for Western District of Washington, Northern Division

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Upon Appeal From the District Court of the United States for Western District of Washington, Northern Division

STATEMENT OF FACTS

This Appeal comes on before this Court upon the stipulated facts (Record 38). A more detailed statement of the facts will be made upon behalf of the appellees.

The bankrupt, PUGET SOUND QUALITY STORES, was incorporated on March 10th, 1930, un-

der the laws of the State of Washington as a cooperative association for the purpose of dealing in groceries and merchandise upon a non profit basis for the benefit of its shareholders. The capital stock was Five Hundred Dollars ($500.00) divided into five hundred (500) shares of the par value of One Dollar ($1.00) each.

The By-Laws were adopted at the first meeting on March 10th, 1930, and approved by all of the stockholders. Article 15, Sections 1, 2 and 3 are as follows:

> "Sec. 1. One percent (1%) shall be added to all statements for the purpose of creating a credit reserve fund. Said one percent (1%) shall be credited to each member's reserve fund account and shall be returnable with interest upon the member ceasing to be a member of the Association, less, however, a pro rata percentage of loss sustained by the Association on account of losses or credit extended to members of the Association."
>
> "Sec. 2. The member's surplus account shall be a guaranty of his account with the Association, it being understood that said reserve fund shall be used to guarantee the accounts of all members with the Association who receive credit."
>
> "Sec. 3. Statements shall be issued to members on the 1st and 15th of each month for goods purchased through or from the Association. The statement of the first of the month shall be delinquent on the 12th of the month, and the state-

ment of the 15th of the month shall become delinquent on the 25th. Credit shall be refused to any member who shall have two such statements unpaid and such credit shall not be renewed until the delinquent accounts of the member are paid. All delinquent accounts will draw penalties of one percent (1%) per week".

Upon its incorporation, the bankrupt engaged in the business for which it was organized and continued operation until July, 1934, when a receiver was appointed by the State Court. On September 20th, 1934, an involuntary petition in bankruptcy was filed in the United States District Court of Western District of Washington, Northern Division, and on October 4th, 1934, the PUGET SOUND QUALITY STORES was adjudicated a bankrupt. In the ordinary course of business until the appointment of a State Court Receiver, the PUGET SOUND QUALITY STORES purchased merchandise in quantities from the manufacturers and jobbers and resold in lesser quantities to its member shareholders who were engaged in the retail grocery business.

Prior to May, 1931, but not thereafter, in accordance with said By-Law, the bankrupt added for credit reserve fund, one percent (1%) of the amount of each statement for merchandise sold by it to its members. The amount of the one percent (1%) so contributed by each member was credited to his individ-

ual credit reserve fund on the books of the corporation. Each claimant whose claim is now under consideration (and other persons similarly situated) is a member of the PUGET SOUND QUALITY STORES holding one (1) share of stock and has paid into the credit reserve fund under the provisions of the aforesaid By-Laws in the course of business prior to May 30, 1931, and has been credited therefor in his individual reserve fund account, the following respective amounts:

R. E. Schoner	$536.94
C. P. Ainsworth	660.91
J. E. Roullard	587.61
O. M. Freeborg	558.32

for which amounts each of said claimants has filed a general claim against the Estate of the Bankrupt, and to which claims the Trustee has filed objections.

The Board of Trustees of the bankrupt, on June 30, 1930, adopted a resolution in words as follows:

> "WHEREAS, the PUGET SOUND QUALITY STORES has accumulated a credit reserve fund for the purpose of covering losses and it is deemed advisable by the Trustees that the investment of this fund in merchandise be discontinued and said fund kept in a liquid state; and the Trustees being desirous of getting a fair return on this fund while still keeping it in a liquid condition in order to fulfill the purpose for which it was created, now,

> Therefore, be it RESOLVED that the officers of this corporation be and are hereby authorized to withdraw its credit reserve fund from its merchandise investment and loan the same from time to time for such period and at such interest as they may deem advisable, keeping in view the fact that said credit reserve funds should be available upon short notice at all times."

The original draft of the minutes has been mutilated by ink obliterating the word or words following and qualifying the said word "losses". Such mutilation was done by those having charge and custody of the corporate records and without the knowledge and consent of the claimants.

Under the authority of that resolution, the officers loaned money from the funds of the corporation to Trade Discount Corporation from time to time during the years of 1930 and 1931 taking notes and renewal notes therefor in the total sum of approximately $45,000.00.

The credit reserve fund of the bankrupt was deposited in the same bank with other funds. During the years 1930 and 1931 the bankrupt operated with a loss and its funds in the bank were drawn upon from time to time to pay its losses.

The minutes of the Board of Trustees of the bankrupt held May 11, 1931, are as follows, to-wit:

"The following resolution was duly offered, seconded and unanimously adopted.

Be it RESOLVED that the By-Laws of this association be amended by striking therefrom sections 1 and 2 of Article XV, and that said amendments be made to take effect June 1st, 1931.

A motion was made, seconded and unanimously adopted that one percent (1%) be added to the costs of merchandise in fixing the selling price of the same, and that the proceeds thereof be placed in the general funds of the Association."

After the adoption of such motion the one percent (1%) was added to the cost of the merchandise in fixing the selling price of the same and the proceeds placed in the general fund of the Association.

Under date of March 30, 1932, an entry was made in the books of the company writing off the credit reserve fund amounting to $42,561.50 as of the date of May 11, 1931. Explanatory note under said entry recites that this change was made as of May 1st, 1931, pursuant to action of the Board of Trustees of June .... (year not stated), and of April 5th, 1932.

The book entry referred to is false and erroneous in that it bears a date prior to the authorization cited to support it.

The claimants neither knew or consented to the action of the Board of any of said meetings or of the

aforesaid book entry and never knew of nor consented to any attempted change in the text or construction of the original By-Laws covering credit reserves or any change or amendment of the original By-Laws.

Certain member shareholders including the claimants herein complained of the management of the affairs of the corporation and were then assured by the manager in February, 1931, that they had, under the By-Laws, a right to their proportionate share of the credit reserve when they withdrew from the credit reserve.

All of the manufacturers' claims against the bankrupt were based upon the merchandise purchased within 60 or 90 days prior to the receivership and the bulk of it prior to 10 days thereto.

Several years ago, from time to time, the officers of the bankrupt discussed its credit, ability, financial standing and its responsibility with its creditors who were selling goods to it. The officers did not represent to the manufacturers that in case of an operating deficit, that the company could reach in and take out of the credit reserve fund money to pay said manufacturers. No present creditor of the bankrupt extended credit to it on the basis of the credit reserve fund being or having been available for general debts

of the corporation or upon the basis of the corporation being free from liabilities to the member shareholders for the return of the funds contributed by them to the credit reserve fund.

The bankrupt is indebted to each of the claimants on account of his credit reserve in the respective amounts shown herein.

The assets of the bankrupt have been reduced to cash and are not sufficient to pay in full the general claims of the creditors whose claims have been filed and allowed exclusive of the claims of the credit reserve claimants which claims have been duly filed.

The referee held that the credit reserve fund was for the purpose of protecting the bankrupt from losses sustained from credit extended to the members of the bankrupt and not for the purpose of protecting the bankrupt from other losses and that such credit reserve fund was applicable to the payment of losses sustained through credit extended to the members and was not applicable to any other losses, debts or expenses and that the bankrupt was indebted to the claimants (appellees) in the amounts set forth less certain deductions to be determined and that such claimants (appellees) herein are general creditors and on a parity with all other general creditors and

are entitled to have their claims allowed and dividends paid.

The referee entered its Order approving such claims in accordance with the findings to which the trustee file objections.

Upon review the District Court of the United States for Western Washington, Northern Division, entered its Order approving and confirming the Order of the referee in all respects.

ARGUMENT OF THE CASE

The ARGUMENT of the appellees will be divided into two parts involving the following propositions of law:

I.

UNDER ARTICLE XV OF THE BY-LAWS, THE CREDIT RESERVE FUND WAS A GUARANTEE OF THE ACCOUNT OF EVERY MEMBER STOCKHOLDER AND WAS RETURNABLE TO EACH MEMBER STOCKHOLDER WITH INTEREST WHEN SUCH STOCKHOLDER CEASED TO BE A MEMBER LESS A PRO RATA PERCENTAGE OF LOSS SUSTAINED BY THE ASSOCIATION ON ACCOUNT OF CREDIT EXTENDED TO THE MEMBERS AND THAT SUCH CREDIT

RESERVE FUND COULD NOT BE USED TO PAY ANY OTHER LOSSES.

II.

THE BANKRUPT IS INDEBTED TO EACH OF THE CLAIMANTS (APPELLEES) HEREIN WHO ARE GENERAL CREDITORS AND ARE ON A PARITY WITH ALL OTHER GENERAL UNSECURED CREDITORS.

I.

This appeal involves the proper construction of the effect and the language set forth in Article XV of the By-Laws of the corporation (Record 39 and 40) which is as follows:

> "Sec. 1. One percent (1%) shall be added to all statements for the purpose of creating a credit reserve fund. Said one percent (1%) shall be credited to each member's reserve fund account and shall be *returnable with interest* upon the member ceasing to be a member of the Association; less, however, a pro rata percentage of loss sustained by the Association on account of losses or credit extended to members of the Association."
>
> "Sec. 2. The member's surplus account shall be a guaranty of his account with the Association, it being understood that said reserve fund shall be used to *guarantee the accounts of all members with the Association who receive credit.*"

"Sec. 3. Statements shall be issued to members on the 1st and 15th of each month for goods purchased through or from the Association. The statement of the first of the month shall be delinquent on the 12th of the month, and the statement of the 15th of the month shall become delinquent on the 25th. Credit shall be refused to any member who shall have two such statements unpaid and such credit shall not be renewed until the delinquent accounts of the member are paid. All delinquent accounts will draw penalties of one percent (1%) per week." (Italics are ours.)

The By-Laws of the corporation constitute a contract between the stockholder and the corporation,

Child vs. Idaho Hewer Mines, 155 Wash. 280, 248 Pac. 80

and have the full force and effect of a statute.

Farrier vs. Ritzville Warehouse Company, 116 Wash. 522, 199 Pac. 984.

"They (By-Laws) must not disturb vested rights or impair the obligations of the contract, take away or abridge the substantial right of the stockholders or members, affect rights of property, or create obligations unknown to law."

7 R. C. L. Page 145, Sec. 117.

"In the interpretation of the By-Laws, the same principles obtained which govern in the interpretation of the Statutes, contracts and other private instruments."

14 C. J. Page 350, Sec. 439.

Since the By-Laws became a contract between the corporation and its member shareholders, the general

rules of the construction of a contract must be applied. If possible, the construction giving effect to all the provisions of the contract should be adopted.

State Life Insurance Co. vs. Allen, 81 Fed. (2nd) 618.

Every provision in the contract must be given effect and must be held to have been inserted for some purpose and to perform some office.

Personal Industrial Bankers vs. Citizen Budget Co., 80 Fed. (2nd) 327.

"A fundamental rule in the construction of agreements where there is an uncertainty, is to ascertain the intent of the parties and in order to do so, the Courts look into the language employed, the subject matter and the surrounding circumstances."

Gilmartin vs. Princeton Bank and Trust Co., 80 Fed. (2nd) 130.

"It is a familiar rule that the contracts will be given a construction which will best effectuate the intention of the parties and this intention must be collected, not from detached portions of the contract but from the contract as a whole. The Court will also in determining the intentions of the parties look to the circumstances under which the contract was made, the subject matter, and the objects and purposes for which it was made. * * *"

"The general purpose and design of a contract will not be permitted to be frustrated by allowing too much force to be given to single words or clauses."

State vs. Comer, 176 Wash. 257, page 263, 28 Pac. (2nd) 1027.

In order to fully understand intentions of the parties at the time of the adoption of said Article 15 of the By-Laws, the surrounding conditions, circumstances and objects for which it was created and the interpretation placed upon said Article 15 after their adoption as shown by the conduct of the parties in the course of their business must be considered.

The corporation was organized as a non-profit cooperative association under the laws of the State of Washington. Its capital stock was limited to $500.00 divided into 500 shares of the par value of $1.00 per share. (Record 39.)

From the date of its incorporation, March 10, 1930, until the appointment of a receiver in July, 1934, it carried on the business of purchasing merchandise in wholesale quantities from the manufacturers and jobbers and in turn selling it in small quantities to its member shareholders who were engaged in the retail business. (Record 40.)

For the special purpose of protecting the association against losses that might arise from the failure of its members to pay for goods purchased of it, Article 15 of the original By-Laws (above quoted) was adopted.

Section 1 of this Article XV reads as follows:

> "Sec. 1. One percent (1%) shall be added to all statements for the purpose of *creating a credit reserve fund.* Said one percent (1%) shall be credited to each member's reserve fund account and shall be *returnable with interest* upon the member ceasing to be a member of the Association; less, however, a pro rata percentage of loss sustained by the Association on account of losses or credit extended to members of the Association." (Italics are ours.)

It, therefore, appears that this Section deals with the method of creating and administering this Credit Reserve Fund.

Section 2 of Article 15 reads as follows:

> "Sec. 2. The member's surplus account shall be a guaranty of his account with the Association, it being understood that said reserve fund shall be used to guarantee the accounts of all members with the Association who receive credit".

It is obvious that this Section is intended to define the obligations of each member's portion of this Credit Reserve Fund. It specifically provides that it shall be a guarantee not only of his account with the association but that it shall also guarantee the accounts of all other members who purchase merchandise of the association on credit. However, this section does not provide that such credit reserve fund

shall be a guarantee to creditors of the association who might sell the association goods.

Section 3 of Article 15 provides as follows, to-wit:

> "Sec. 3. Statements shall be issued to members on the 1st and 15th of each month for goods purchased through or from the Association. The statement of the first of the month shall be delinquent on the 12th of the month, and the statement of the 15th of the month shall become delinquent on the 25th. Credit shall be refused to any member who shall have two such statements unpaid and such credit shall not be renewed until the delinquent accounts of the member are paid. All delinquent accounts will draw penalties of one percent (1%) per week".

It seems quite apparent that the purpose of this Section is to limit the extent to which the members of the association will be called upon to guarantee the credit of any other member. It places a very definite limitation as to the period of time over which credit is to be extended to any member. No member is to be entitled to credit for a longer period than approximately one month. In addition, each member is discouraged from extending his credit beyond one month, by the imposition of a rather heavy penalty of 1% per week after the delinquency of two statements. In other words, a study of the entire article including all three sections, shows that the entire Article is concerned primarily with one subject and with one object in view to-wit: the protection of the association

from loss resulting from credit extended to members upon merchandise sold by it to them. To meet that hazard a credit reserve fund is created and as a natural incident thereto, each member's own reserve fund is created. The method adopted is to add one percent to all statements for merchandise purchased. The total of these member reserve fund accounts become the "Credit Reserve Fund".

This fund is to be used as a guarantee against losses on account of credit extended to members. Upon termination of the membership, such member is assured that he will be entitled to the return of his credit reserve fund with interest less a pro rata percentage on account of losses sustained or to accrue because of credit already extended to any member of the association.

The appellant, however, directs attention to the word "losses" in Section 1, and claims that the same affords a basis for his contention that this credit reserve fund was created to guarantee not only losses on account of credit extended to members, but in addition thereto, any losses which the association might sustain in the operations of its business.

> The appellant says "the only reasonable conclusion to be reached is that before any member of the bankrupt would be entitled to the return of his credit reserve fund, he would have to first

> be charged with his pro rata percentage of losses sustained by the bankrupt in the general operation of the business and also to losses sustained on account of credit extended to its members." (App. Br. p. 15.)

In other words, the appellant would introduce an additional subject and object in Article 15, to-wit: "operating losses". Thus under the appellant's contention Article 15 would provide a Credit Reserve Fund for two objects, to-wit: (1) pay operating loss, and (2) pay losses sustained from credit extended to members. The appellant contends that the clause, "loss sustained by the Association on account of losses," makes each member's reserve fund a guarantee against any loss from the operation of its business and it requires the association to deduct from the reserve fund account of any member withdrawing from membership a pro rata of all losses sustained by the association.

The entire Article 15 must be considered as a whole and each any every part thereof, and all of the language used in Sections 1, 2 and 3 must be given full force, weight and effect in its entirety. If the appellant's contention is correct that the Credit Reserve Fund established by such Article 15 could be used to pay any loss or debt, then said Section 1 would end and should have ended with the words,

"loss sustained by the association", and the words following, to-wit: "on account of losses or credit extended to members of the association," should be eliminated. However, the said Section does not stop with the word "association" but continues with a restrictive and qualifying clause. It is significant that the appellant does not claim any ambiguity but does characterize the language in said Section 1 as awkward. (App. Br. p. 15.)

Let us see, however, if the language of this Section could be easily interpreted to include the appellant's contention. Suppose that the latter part of Section 1 read, "less, however, a pro rata percentage of loss sustained by the association on account of losses", would not such language be entirely meaningless? What could the Court say was the meaning of "loss sustained by the association on account of losses?" Under the appellant's interpretation you would have the word "loss" restricted and qualified by the word "losses." The word "loss" is a generic term and unless restricted would include the entire class of obligations.

However, this By-Law does not leave us in any such dilemma. As adopted, it reads, "less, however, a pro rata percentage of losses sustained by the association on account of losses or credit extended to the

members of the Association". The added clause, "on account of losses or credit extended to members," clarifies the whole situation. Let us apply it to the actual subject of Article 15. Remember we are dealing with credit extended to members. Credit has been extended to members and perhaps a loss has already been incurred by the association by reason of credit extended to some member who has become insolvent or who refuses to pay. On the other hand, the association has accounts against other members for goods purchased upon credit but no losses have been sustained therefor, as yet. Such members will probably pay in due course.

The disjunctive word "or" was used between the words "loss" and "credit" for this very definite purpose.

When a member who had paid into the credit reserve fund, desired to withdraw, he was entitled to have his credit reserve fund returned to him with interest less any loss or probable loss arising from the failure of the other members who had purchased their merchandise on credit to pay their accounts for such merchandise. At the time of such withdrawal, the officers of the bankrupt association would have to determine the amount of the deductions to be made, if any, from the credit reserve fund of the member with-

drawing. It would be easy to fix the loss where a member to whom credit had been extended had actually failed and could not pay his bill. But, there would be other members to whom credit had been extended and who had not failed but might fail in the future. This created a condition where a possible loss might be sustained by the Association.

If Section 1, Article XV of the By-Laws had only read "on account of losses for credit extended to members of the Association", the withdrawing member could justly argue and contend that the only deduction from his credit reserve fund to be made at such time, would be those losses actualy fixed at the time of withdrawal and would not include any future losses arising out of credit being extended to the member who at the time of withdrawal had not failed but was indebted to the Association, and who might fail in the future thus creating a loss; in other words, the liability of loss would exist without the actual amount having been determined at the time of withdrawal.

Thus we have two (2) conditions as fixed in said By-Law:

1. Where the loss is determined and ascertained arising out of credit extended to a member who had actually failed at the time of withdrawal, and

2. Where credit has been extended to a member who had not actualy failed at the time of withdrawal but who did fail at some future date and which loss could not be determined at the time of withdrawal.

This is a reasonable and logical explanation of the language of Section 1, Article XV of the By-Laws, and gives full force and effect to each and every part thereof.

The acts and conduct of the officers and member shareholders and all persons doing business with said association must be considered in determining the true meaning of the language used in said Article XV. In this connection, the manner in which this credit reserve fund was handled from the beginning until its repeal on May 30, 1931, sheds light upon the interpretation placed upon such By-Laws by the officers, the member shareholders and all persons doing business with such association. The corporation set up a record on its books, crediting such shareholder with the amount of money that he had contributed to the credit reserve fund. (Record 41.)

On June 30, 1930, the Directors adopted a resolution discontinuing the investment of said funds in merchandise and loaned the same at a rate of interest with a view to have such funds available upon

short notice. This resolution recited amongst other things, the following language, to-wit:

> "WHEREAS, the PUGET SOUND QUALITY STORES has accumulated a credit reserve fund for the purpose of covering losses * * *"

following the word "losses" were word or words qualifying the meaning of the word "losses" which had been mutilated by those having charge and custody of the corporate records and without the knowledge or consent of the claimants (appellees). (Record 41-42.)

> "So spoilation or destruction by a party of paper and books gives rise to a presumption unfavorable to him since his conduct may be properly attributed to his supposed knowledge that the truth would operate against him."
>
> 10 R. C. L. Page 885, Sec. 32.

In this case, words would be presumed to have modified the word "losses" in such resolution as to restrict the word "losses" to such losses arising out of credit extended to the members and not to any other loss or losses.

Under this resolution it is clear that the credit reserve fund was deemed a special and separate fund and in fact a trust fund.

> *In re*: *Newark Shoe Stores et al.*, 23 A. B. R. N. S. 228.

However, the appellees did not attempt to trace such funds into any particular fund of the Bankruptcy and are simply general creditors.

> Gilbert's Collier (4th Ed.), Sec. 1290, Page 1011.

In accordance with this resolution, the money was loaned to Trade Discount Corporation and was evidenced by demand notes totalling $45,000.00. At various times the management of the bankrupt assured the members that the credit reserve was intact and that they were entitled to their proportionate share when they withdrew from the corporation. (Record 42.)

It is apparent that when the credit reserve fund had reached the aforesaid sum of $45,000.00, that it was more than sufficient to protect the Association against losses arising out of credit extended to members who purchased goods. A general depression began to manifest itself in the business world. The Board of Trustees of the bankrupt determined to stop the accumulation of the credit reserve fund and without burdening the merchants, added one percent (1%) to the cost of the merchandise placing the same in the general fund of the corporation by amending the By-Laws. This was done on May 11, 1931. (Record 43.) By such amendment to the By-Laws, the

Board of Trustees made the funds available to pay general expenses and clearly indicating that the credit reserve fund was not available to pay general expenses or general losses.

No person or corporation selling goods to the bankrupt was ever deceived or mislead to believe that such credit reserve fund could be used to pay any and all losses or to pay his or its bills for merchandise sold to the association, (Record 45).

During the years 1930 and 1931 when the bankrupt was operating at a loss (Record 43), the parties did not use this credit reserve fund with which to pay losses but set it aside and apart from the general fund of the bankrupt loaning the same to Trade Discount Corporation on demand notes so that such fund would be liquid and available to pay each member shareholder his share when he withdrew from the corporation. Such action is contrary to the ordinary custom and practice of business.

During the entire course of years, the officers and the member shareholders and the persons dealing with the association treated such credit reserve fund as belonging to the individual contributing the same and as available only to be used to pay the losses arising out of the credit extended to the members and not for any other loss or debt.

If the contention of the appellant is correct that such credit reserve fund was available to pay every loss and debt, then no action of the Board of Trustees would have been necessary to discontinue the collection of the one percent (1%) for the credit reserve fund nor attempt to write off the credit reserve fund on the books of the corporation which latter action was fraudulent. This action on the part of the officers and Board of Trustees clearly shows that they interpreted the original Article XV of the By-Laws to mean that the Credit Reserve was a special fund available only to pay losses arising out of credit extended to the members and could not be used for operating expenses. (Record 43.)

On March 30, 1932 the officers fraudulently attempted to write off the Credit Reserve under the authority of the resolution alleged to have been passed by the Board of Directors. Such book entry was false and erroneous and bears a date prior to the date of authorization cited to support its action. The claimants neither knew or consented to such action. (Record 44.) This clearly shows that the officers by attempting through fraud and deceit to charge off the credit reserve knew and did interpret said Article XV to mean that such credit reserve fund could only be used to pay for the losses

sustained by the Association on account of credit extended to members. If the credit reserve could have been used to pay all lossess, then naturally the officers and manager of the bankrupt would have advised the party selling merchandise to it that in addition to its capital fund, the credit reserve fund could be used to pay the claims. This was never done. No present creditor of the bankrupt extended credit to it on the basis of the credit reserve fund being or having been available for general debts of the corporation or upon the basis of the corporation being free from liabilities to the member stockholders for the return of the funds contributed by them for the credit reserve fund. (Record 45.)

By the acts and conduct of the Board of Directors and Manager of the bankrupt and the member shareholders and the parties selling merchandise to the bankrupt, each one has placed the interpretation of the construction of said By-Laws as contended for by appellees, namely, that such reserve fund was for only one specific purpose, to-wit: to pay the losses arising out of credit extended to members and no other losses.

This is the interpretation placed upon such By-Laws by the Order of the Referee and the Order of the District Court.

II.

THE BANKRUPT IS INDEBTED TO EACH OF THE CLAIMANTS (APPELLEES) HEREIN WHO ARE GENERAL CREDITORS AND ARE ON A PARITY WITH ALL OTHER GENERAL UNSECURED CREDITORS:

The By-Laws provided for the repayment of the amount of the credit reserve together with interest to each member for the amount he had so contributed. The relation of debtor and creditor was established by such By-Laws between the members contributing to the credit reserve and the corporation.

> *Com. vs. Berkshire Life Insurance Co.*, 98 Mass. 25.
>
> "Interest at a fixed rate stipulated to be paid on a sum is prime facie evidence, but not necessarily conclusive evidence that the transaction is a loan, namely the relation of debtor and creditor."
>
> *In the matter of the Newark Shoe Stores et al.*, Vol. 23 A. B. R. N. S., Page 228.

The bankrupt established such credit reserve on its books in favor of each member contributing to such fund and the officers of such bankrupt regarded the same as a loan although once or twice they attempted to fraudulently use said reserve fund for other purposes. The referee found the said attempts

to be void and fraudulent and further that the bankrupt was indebted to each of the appellees in the sum set forth which findings were approved by the District Court. These findings are binding upon the appellant and are presumed to be correct until the contrary is shown. The burden of proof is upon the one objecting.

In re: *Burntside Lodge*, 7 Fed. Sup. 785-7.

The appellant contends that the credit reserve fund was a working capital fund and in the nature of a contribution to the capital.

Sec. 3905 of Rem. Rev. Statutes of Washington provided that the Articles of Association shall be in writing and shall set forth the name of the Association, the purpose for which it was formed, place of business and the length of existence and (5) the amount of capital stock, the amount of each share, the number of shares and the par value of each share.

Sec. 3909 of Rem. Rev. Statutes of Washington provides that the Articles of Association may be amended by majority vote of the stockholders at a regular meeting of stockholders or at a special meeting called for the purpose on 20 days written notice and the capital stock may be increased or decreased. The statute of State of Washington fixed the method

of increasing and decreasing the capital stock which can only be done through the amendment of the Articles of Incorporation and no other way is permissable.

> "By-Laws of the corporation which are contrary to or inconsistent with its charter, Articles of Association or Incorporation, or governing statutes are ultra vires and void even though they may have been unanimously assented to by the Stockholders or members."
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> 14 C. J. Page 362, Section 460.
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> "Corporations have no power to create By-Laws that are unreasonable in their application or that are violative of the statutes of the State."
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> *Peoples' Home Savings Bank vs. Superior Court of San Francisco*, 104 Cal. 649, 38 Pac. 452.

Statutes of the State of Washington fixes the liability of the stockholders for unpaid subscription for stock.

> Rem. Rev. Stat. of Wash., Sec. 3921,

and the company cannot enlarge such liability by By-Laws.

> *Traders and Mechanics Company vs. Grounds* (Mass.), 8 N. E. 134.

By-Laws cannot change the Articles of Incorporation and cannot increase or diminish capital stock of any corporation. If any such By-Law attempts to do this, it is void.

The reasonable and proper construction of the By-Laws to make it effective for the purpose for which it was enacted would be that this By-Law did not attempt to amend the Articles of Incorporation or create an additional capital fund, but was a guarantee fund to protect the association from loss by reason of credit being extended to the members upon the purchase of merchandise and limited the credit reserve fund to payment of such loss and not any other loss or debt.

Although a person may be a stockholder of a corporation which is bankrupt, yet such person may be a creditor of the corporation. As such creditor he would be entitled to file and have allowed his claim with other creditors of similar rank.

In re: *Burntside Lodge, Inc.*, 26 Am. B. R. (N. S.) 59, 7 Fed-Sup. 785.

Wheeler vs. Smith, 30 Fed. (2nd). 59, (9th C. C. A.).

Collier Bankrupt, 13th (Add.) Page 1381, Sec. 63 (3).

In re: *Stone Moore West Co.*, 292 Fed. 1004.

In re: *Pneumatic Tube Steam Splicer Co.*, 60 Fed. (2nd Add.) 524.

The claims of the appellees for their credit reserve were filed and allowed as general claims against the association and on a parity with all other general

creditors. The parity of the claims of the appellees with other general creditors is covered by proper construction to be placed on a single section of the bankruptcy act which applies to the present situation.

Bankruptcy Act, Sec. 64-B, Subdivision 7, 11 U. S. C. C. A., Sec. 104-B, Sub. (7).

Amongst other things, said Section provides as follows, to wit:

> "B—The debts to have priority in advance of the payment of dividends to creditors and to be paid in full out of the bankrupt estates and the order of payment shall be
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> 7. Debts owing to any person who by the laws of the states or the United States is entitled to priority provided that the term "person" as used in this section shall include corporation, the United States and the several States and territories of the United States."

The laws of the State of Washington provide that in the proceedings for the dissolution of a corporation subject to the supervision of the Court, the following matter shall be covered by the same rules as are applicable in bankruptcy proceedings; under the National Bankruptcy Act as in force at the time of bankruptcy proceedings;

2. All questions in respect to proof, allowance, payment and priority of the payments of claims,

Sections 3803-57 of the Uniform Business Cor-

poration Act. Rem. Rev. Statutes of Washington, Supp. Statutes.

Laws of 1933, page 812, Section 57.

Under the laws of the State of Washington, the claims of the appellees are general claims and would be on a parity with all other general creditors.

West Land vs. Post Land Co., 115 Wash. 329 197 Pac. 44.

Dooley Co. vs. Seattle Electric, 140 Wash. 227 248 Pac. 373.

Briggs & Co. vs. Harper Clay Products Co., 150 Wash. Page 235-240, 272 Pac. 962.

"Before a general creditor's claim against the bankrupt may be disallowed or its status lowered, it must appear that said creditor has been guilty of some act involving moral turpitude or some breach of duty or some misrepresentation whereby other creditors were deceived to their damage."

Bowman Hardware & Electric Co., 24 A. B. R. N. S. 405, 67 Fed. (2nd) 792.

Collier on Bankruptcy, page 1384, Edition 13.

Ingram vs. Lehr, 16 Am. B. R. N. S. 215, 41 Fed. (2nd) 169 (9 C. C. A.).

Wheeler vs. Smith, 30 Fed. (2nd) 59.

The appellees acted in good faith and have at all times insisted upon the right of payment of the credit reserve due them from the bankrupt less pro rata loss sustained by the association on account of losses

from credit extended to its members. The other general creditors were not mislead or injured in any respect and did not extend credit upon the belief that the credit reserve fund could be used to pay all losses. Such credit reserve fund is a liability against the bankrupt. The claims of the appellees for credit reserve are on a parity with all other general creditors and no equitable principles are involved which would reduce it.

CONCLUSIONS

In conclusion, the appellees contend as follows:

I.

That the original By-Laws of the bankrupt provided for the creation of a credit reserve fund for the protection of the bankrupt against losses through credit extended to the members of the bankrupt and not for the purpose of protecting the bankrupt against any other losses and

II.

That such credit reserve could only be used in payment of the losses sustained through extending credit to the members and could not be used for any other loss, debt or expenses.

III.

That under the By-Laws a bankrrupt is indebted to each of the appellees for the amount of his contribution to the credit reserve less the deductions for the losses sustained through the extension of credit to the members and not for any other purpose.

IV.

That any change in the By-Laws was ineffective and void and done without the consent of the appellees.

V.

That the general creditors did not extend credit to the bankrupt on the basis of credit reserve fund and the appellees are not barred on the ground of estoppel or otherwise.

VI.

That the claimants are general creditors and are on a parity with all other general unsecured creditors and are entitled to have their claims allowed and paid accordingly therewith.

For the foregoing reasons it is submitted that the appeal of the appellant should be dismissed and the Order of the Referee and the Order of the District Court of the United States for the Western District

of Washington, Northern Division, should be approved and confirmed.

Respectfully submitted,

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